

VZCZCXYZ0003
PP RUEHWEB

DE RUEHMO #2308/01 2210809
ZNY CCCCC ZZH
P 080809Z AUG 08
FM AMEMBASSY MOSCOW
TO RUEHC/SECSTATE WASHDC PRIORITY 9364
INFO RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUCPDO/DEPT OF COMMERCE WASHDC PRIORITY
RHEHNSC/NSC WASHDC PRIORITY

C O N F I D E N T I A L MOSCOW 002308

SIPDIS

STATE FOR EUR/RUS, EEB/IFD
TREASURY FOR TORGERSON
DOC FOR 4231/MAC/EUR/JBROUGHNER
NSC FOR WARLICK

E.O. 12958: DECL: 08/08/2018
TAGS: [ECON](#) [EFIN](#) [RS](#)
SUBJECT: WHAT DOES THE MEHEL INCIDENT MEAN?

REF: MOSCOW 2201

Classified By: ECMIN Eric T. Schultz, Reasons 1.4 (b/d).

Summary

¶1. (C) The Mechel incident (Ref A) has been a sobering initial test of the new administration's management of the economy. On the heels of the TNK-BP dispute, Mechel unleashed precipitous stock market losses and struck a blow to previously bullish sentiment on Russia's investment climate. Optimists among local analysts hope to see the markets reverse their losses this fall and hope to see the GOR learn from its mistake. More pessimistic analysts point to this as evidence that it's business as usual in Russia, with official corruption and government control the dominant characteristics of the economy. From our perspective, we believe this incident has exposed a fundamental contradiction in the regime's economic goals: promoting economic modernization may be incompatible with regime insiders' continued control of the commanding heights of the economy. End Summary.

Mechel as Target, Lesson

¶2. (C) Troika Dialog metals and mining analyst Aleksey Kuznetsov told us investor confidence suffered after Putin called on the Federal Antimonopoly Service to investigate steelmaker Mechel's tax avoidance practices as well as its record of price gouging in domestic sales of coking coal. The market had perceived Mechel as firmly within the government's good graces as evidenced by its broad array of defense contracts. Consequently, investors' uncertainty about the standing of other industrial firms and blue chip companies pushed leading indices sharply lower as visions of Yukos danced in their heads.

¶3. (C) Kuznetsov allowed that Mechel, like other steel and metals producers whose share prices suffered following Putin's remarks, might have engaged in transfer pricing schemes, wQch, in turn, may have affected the market supply of steel and put upward pressure on inflation. He contended, however, that coking coal prices were rising globally and that Putin's accusation may have been part willful ignorance. The allegation that Mechel had restricted coking coal sales domestically and charged twice the price of its foreign sales compared the apples of spot market transactions with the oranges of long-term contracts, according to Kuznetsov. The spot market routinely feature comparatively higher per-unit

prices for quick delivery in contrast with relatively lower per-unit prices offered by long-term contracts.

14. (C) Citibank Russia's Investments Director Irakliy Mtibelishvili told us his view was that Putin had no idea his comments would have sparked a USD 60 billion loss in market capitalization in one day. The Prime Minister knew that his oligarch-bashing and tough words on inflation would be well received, but he had not factored in that investors would interpret his comments as "post-TNK-BP piling on." Deputy Director of the MFA's North America Department Nikolai Smirnov also told us that Putin had seen little danger in shining the spotlight on Mechel since Russia had survived the dire predictions that emerged following the case against Yukos. Smirnov said, however, that the stock market was now substantially larger and more important to the country's economic health. He said he hoped senior leaders would learn from Mechel and be more cautious in their public discussions of economic policy.

Optimists: Fundamentals Remain Strong

15. (SBU) Deutsche Bank Senior Equity Analyst Georgiy Kartashov shared Smirnov's optimism and added that a reassuring statement from officials would turn the market around. He explained that companies' fundamentals -- their business models, their access to capital, and their profitability -- had not changed significantly since the slump that took over the country's exchanges in mid-May. The current bout of continuing declines represented investors' efforts to re-price Russia's risk premium. Moreover, Kartashov asserted, Russian stocks at their current level were undervalued.

16. (C) Renaissance Capital's (RenCap) revised stock market growth estimate for the year, which they released earlier this week, warned of increased risk premiums following Mechel but nonetheless echoed Kartashov's assessment of the market's valuation. RenCap predicted that the market would bounce back in the fall. Although they no longer predicted that the benchmark RTS would reach 3,000, or 50 percent growth, by year's end, the amended forecast of 2,350 for the benchmark RTS anticipated a substantial rally given that the index was below 1,900 when the new outlook was published. Like RenCap, UniCredit Aton also cited higher risk premiums as the basis for its lower year-end target for the RTS, but forecast an even more bullish 2,530.

The Gap between Policy and Practice

17. (C) Standard & Poor's-Russia Managing Director Aleksey Novikov conceded that Russian firms' generally sound business practices might calm investors' nerves but observed that Putin's threat of using administrative agencies to control the business environment had unsettling overtones. Novikov portrayed the Federal Antimonopoly Service as simply the latest preferred lever to address the symptoms of economic ailments, this time for combating inflation under the guise of promoting competition. He said the GOR deployed the Federal Tax Service to campaign against "criminality" as well as the adverse effects to the budget of shipping profits offshore. Novikov concluded that the Mechel incident would intimidate "troublesome" industries and companies and encourage greater "discipline" but would probably muffle debate on how best to alleviate inflation.

18. (C) Institute of Energy and Finance President Leonid Grigoriev said Putin spoke out forcefully against Mechel "because he thought action was needed," with little regard for the consequences. He compared this to the government's policy with respect to state corporations, an "easy" but flawed approach to the country's modernization needs. State corporations applied state resources toward an economic objective but with no articulated or discernible plan for

transferring their gains to the broader economy. Nevertheless, the government continued to support this approach because it was seen as taking "action" to modernize the economy, filling in where market participants had not. Grigoriev concluded that the Mechel case, like the policy supporting state corporations, reflected a continuation of the government's "desperate strategy" to promote economic growth.

¶9. (C) Grigoriev said the Mechel incident also revealed a government that was coming to grips with "its impossible mission" of sustaining economic growth without exacerbating economic weaknesses. Senior officials recognized the need to remedy the country's lagging productivity and weak supply response to rising living standards and increasing demand. This recognition had informed much of Medvedev's Krasnoyarsk speech and the call to create an innovation economy. Economic modernization, however, was a long-term endeavor while poor infrastructure, inadequate health care, and inflation were adversely affecting the country now. Grigoriev suggested that officials have realized that budget resources might have effectively addressed these challenges early in Putin's first term without feeding inflation. Now it was too late, and Putin had taken aim at Mechel "out of frustration that the conventional tools for controlling inflation have not produced results."

Unlimited Legal Nihilism?

¶10. (C) Novikov said that if the Mechel case is an elite-driven scheme to take over Mechel, it would mean that the state's position in the economy might become even more pervasive. He conceded that the state would probably always jealously guard traditional powerhouse industries like metals and oil and gas. However, the implication of Mechel's possible acquisition by Putin and/or his fellow elites was an unstable investment climate. No observer, analyst or investor would be able to rely on indicators that firms in these industries were upstanding corporate citizens. Mechel's tax payments had been in keeping with those of other steelmakers; the Federal Antimonopoly Service had approved the firm's acquisition of its coking coal assets, making the firm the second-largest supplier in Russia; and the firm had enjoyed lucrative defense contracts for years, according to Novikov.

¶11. (C) Novikov concluded that the move against Mechel justified JP Morgan's recommendation to "underweight" Russian stocks, as well as Renaissance Capital's downgraded forecast for the benchmark RTS, which predicted growth of only 17.5 percent vice the 50 percent RenCap was expecting as recently as May of this year. Masha Lipman, editor of the Carnegie Moscow Center's Pro et Contra, was even more blunt, telling us that the campaign against Mechel was obvious and that "it's clear Mechel will be redistributed, to somebody." With obvious consequences for investor confidence.

Comment

¶12. (C) Legal reform has been a key priority among Medvedev's stated goals for creating a modern "innovation" economy. Streamlining administrative barriers and eliminating corruption will lead to the further development of small businesses, which in turn will drive efficient, private sector growth. Against this backdrop, the speculation that the elite's interest in acquiring Mechel may have motivated Putin's attack is all the more troubling to investors, since it suggests that when push comes to shove, senior GOR officials will continue to use their positions to shake down businesses regardless of the effects on the broader economy. End Comment.
RUBIN